

DESCRIPTION OF S. 2388
RELATING TO
EMPLOYER EDUCATIONAL ASSISTANCE
PROGRAMS
LISTED FOR A HEARING
BY THE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT
OF THE
COMMITTEE ON FINANCE
ON JANUARY 20, 1978

PREPARED FOR THE USE OF THE
COMMITTEE ON FINANCE
BY THE STAFF OF THE
JOINT COMMITTEE ON TAXATION



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I. INTRODUCTION

This bill, S. 2388, described in this pamphlet has been scheduled for a hearing on January 20, 1978 by the Subcommittee on Taxation and Debt Management of the Committee on Finance. The bill relates to the tax treatment of employer educational assistance programs.

In connection with this hearing, the staff of the Joint Committee on Taxation has prepared a description of the bill. The description indicates the present law treatment, the issues involved, an explanation of what the bill would do, the effective date of the bill, its revenue effect, and the Treasury Department position.

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II. BACKGROUND

A. PRESENT LAW

Under present law, the issues concerning whether money or benefits furnished to an individual to assist him in his education are includable in income generally are governed by sections 61 and 117 of the Code. Section 61 provides that, unless otherwise excluded by law, gross income means all income from whatever source derived including, but not limited to, compensation for services. Under section 117, subject to certain qualifications, amounts received as scholarships at educational institutions and amounts received as fellowship grants are excluded from gross income.¹ The exclusion also covers incidental amounts received to cover expenses for travel, research, clerical help, and equipment when they are expended for these purposes.

The exclusion for scholarships and fellowship grants is restricted to educational grants by relatively disinterested grantors who do not require any significant consideration from the recipient.²

With respect to the deductibility of educational expenditures under present law (Reg. §1.162-5), expenditures made by an individual for his own education generally are deductible if they are for education that (1) maintains or improves skills required by the individual's employment or other trade or business, or (2) meets the express requirements of the individual's employer or the requirements of applicable law or regulations imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation. These types of education are commonly called "job-related education." However, no deduction is allowed for expenditures for education required of the individual in order to meet the minimum educational requirements for employment qualification in the individual's employment or other trade or business or for expenditures for education which is part of a program of study which will qualify the individual in a new trade or business. Such expenses may not be deducted even if the education maintains or improves skills required by the individual in the individual's employment or other trade or business or meets the express requirements of the individual's employer or applicable law or regulations. Nondeductible educa-

¹ To some extent, qualifications differ for individuals who are candidates for degrees and individuals who are not degree candidates. A degree candidate cannot exclude any amount to the extent it represents compensation for teaching, research, or other part-time services which he or she is required to render in order to obtain the grant unless such services are required of all candidates for a particular degree as a condition for receiving the degree.

In the case of a non-degree candidate, the exclusion is available only for up to \$300 per month for no more than 36 months and then only if the grantor of the scholarship is a qualified governmental unit, charity, or international organization.

² *Bingler v. Johnson*, 394 U.S. 741 (1969).

tional expenditures are personal expenses of the employee. Similarly, expenses which are incurred by an individual for recreation and which are not connected with a trade or business or the production of income, such as taking courses with respect to a hobby, are personal expenses of the individual and are not deductible. Thus, unless the education expenses are deductible to the individual under the above rules, an employee ordinarily will have income which is not offset by deductions in the following situations:

(1) the employee is reimbursed for educational expenses by the employer;

(2) educational expenses of the employee are paid directly by the employer; or

(3) the employer furnishes educational services directly to the employee.

An employer normally will be able to deduct amounts paid or incurred to provide educational assistance to employees because such amounts will be treated as compensation under section 162.³ However, such amounts may be nondeductible as excessive compensation or, in some cases where the employees benefited are shareholders, as dividends.

Generally, unless specifically excluded by statute, all remuneration paid to employees, regardless of the form in which paid, constitutes wages subject to withholding of income and employment taxes. Remuneration is not necessarily excluded from the definition of employment tax wages simply because it is excludable from gross income under some other section of the Code. However, Treasury regulations provide that certain advances and reimbursements paid to employees for ordinary and necessary business expenses are excluded from the definition of wages for withholding and employment tax purposes. Pursuant to these regulations, the Internal Revenue Service has ruled that educational expenses paid on behalf of, or reimbursed to, an employee for courses which maintain or improve skills required in employment, or meet express requirements of an employer as a condition to retaining employment, (that is, job-related educational expenses), are excludable from the wages of the employee for purposes of employment taxes and withholding. If the education courses do not satisfy these tests, their cost is considered a personal expense of the employee and the advance or reimbursement is includable in wages and subject to employment taxes and withholding.⁴

B. ISSUES

The primary issue presented by this bill is whether it is appropriate to provide an exclusion from gross income for expenses paid or incurred, or benefits furnished in kind, by an employer to provide educational assistance to an employee in situations where (1) these amounts

³ In situations where an employer acquires items with a useful life in excess of one year and uses them for the direct furnishing of educational assistance to the employees, the cost would have to be recovered through deductions for depreciation over the useful lives of such items. In other situations, the deductions would normally be allowed when the amount is paid or incurred (depending on the employer's method of accounting).

⁴ See Treas. Reg. §§ 31.3121(a)-1(h), 31.3306(b)-1(h), and 31.3401(a)-1(b) (2); Rev. Ruls. 76-62, 1976-1 C.B. 12, 76-71, 1976-1 C.B. 308, and 76-352, 1976-2 C.B. 37.

do not qualify for exclusion as scholarships or fellowship grants, and (2) the expenses are not job-related and therefore not deductible by the employee under present law.

Assuming that the primary issue is resolved in favor of providing an exclusion for at least some of these amounts, a number of related issues arise, including the following:

- (1) should any conditions or limitations be placed on the eligible recipients, the employer, or the amounts received or paid;
- (2) should any limitations be imposed on the type of education or the identity of the party furnishing the education; and
- (3) should these amounts be treated as wages for purposes of income tax withholding, social security taxes, and unemployment taxes.

III. DESCRIPTION OF S. 2388

The bill, introduced by Senator Packwood for himself and Senators Javits and Nelson, excludes from an employee's gross income amounts paid for expenses incurred by the employer for educational assistance to the employee if such amounts are paid or such expenses are incurred pursuant to a program which meets certain requirements. In the case of education paid for or furnished by an individual's employer, the bill eliminates the need to distinguish job-related educational expenses from personal ones for income tax purposes.⁵

The educational benefits which may be excluded from income are those furnished by an employer only to employees. However, the types of educational assistance which may be furnished are not restricted. Thus, the employer may provide educational assistance to the employee directly or the employer may reimburse the employee for his expenses. Under the bill, an employee could exclude from income tuition, fees, and similar payments, and the cost of books, supplies, and equipment paid for or provided by his employer; however, the employee cannot exclude tools or supplies which the employer provides and which the employee may retain after completion of the course of instruction. Meals, lodging, or transportation also may not be excluded. There is no limitation on who furnishes the educational assistance; such assistance may be furnished by an educational institution or any other party. Also, the employer (alone or in conjunction with other employers) may furnish the education directly to the employees. The education which may be furnished is not limited to job-related courses nor to courses which are part of a degree program. There are no requirements that a program obtain advance approval from the Internal Revenue Service nor that it be funded.

In order to be a qualified program, an educational assistance program also must meet requirements with respect to nondiscrimination in contributions or benefits and in eligibility for enrollment. The bill requires that the benefits provided under a program may not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly-compensated. The bill specifically provides that a program shall not be considered discriminatory merely because it is utilized to a greater degree by one class of employees than by another class or because successful completion of a course, or attaining a particular course grade, is required for, or considered in, determining the availability of benefits.

A limit is placed on the proportion of the amounts or benefits provided under the program which can be for employees who own more than 5 percent of the stock or of the capital or profits interest in the

⁵ However, such a distinction would still have to be made in situations where the education is not paid for nor furnished by the individual's employer.

employer corporation or unincorporated trade or business. The aggregate of the contributions for those employees and their spouses and dependents must not be more than 25 percent of the total contributions.

An individual who qualifies as an employee within the definition in section 401(c)(1) of the Code is also an employee for purposes of these provisions. Thus, in general, the term "self-employed individual" means, and the term "employee" includes, individuals who have earned income for a taxable year, as well as individuals who would have earned income except that their trades or businesses did not have net profits for a taxable year.

An individual who owns the entire interest in an unincorporated trade or business is treated as his own employer. A partnership is considered the employer of each partner who is also an employee of the partnership.

For determining stock ownership in corporations, the bill adopts the attribution rules provided under subsections (d) and (e) of section 1563 (without regard to sec. 1563(e)(3)(C)). The Treasury Department is to issue regulations for determining ownership interests in unincorporated trades or businesses, such as partnerships or proprietorships, following the principles governing the attribution of stock ownership.

Effective date.—The bill would apply to taxable years beginning after December 31, 1977.

Revenue effect

It is estimated that S. 2388 will decrease tax liability by \$23 million for calendar year 1978, \$26 million for 1979, \$29 million for 1980, \$32 million for 1981, \$36 million for 1982, \$40 million for 1983, and increasing amounts thereafter.

Departmental position.

The Department of the Treasury opposes a general statutory exclusion from income for employer-provided educational assistance primarily because it believes that such an exclusion would be unfair.

IV. ANALYSIS

As is the case with any proposed exclusion, this bill raises the issue of whether it is appropriate to provide an exclusion which encourages a particular activity but which also narrows the income tax base. Any proposed exclusion raises horizontal equity problems. Thus, it may be relevant to consider whether the disparity between persons with equal incomes will be increased or decreased by this bill. Also, because exclusions frequently tend to reduce the progressivity of the income tax (thereby reducing vertical equity), it may be appropriate to consider the extent of the decrease in progressivity and whether such a decrease is desirable. Furthermore, the issue of whether this exclusion increases or decreases complexity should be addressed.

Under the bill, the type of educational assistance which could be paid for or furnished tax-free by the employer includes many expenses which, even under a liberal interpretation of the law, are presently considered personal. It might be desirable to consider whether some type of job nexus should be required.

Alternatively, the rules relating to the deductibility of educational expenses could be reexamined with a view to simplifying and, perhaps, liberalizing them.

The bill also raises issues relating to employment tax and withholding requirements. The bill does not distinguish between educational assistance which is job-related and that which is personal. However, in order to comply with employment tax and withholding requirements, the distinction between job-related and personal educational expenses would still have to be made. The job-related assistance would not be subject to employment taxes or withholding under present law, but the assistance relating to courses taken for personal purposes would be subject to such taxes. The committee may wish to consider whether or not educational assistance covered by the bill should be excepted from employment taxes and withholding without regard to whether it is job-related or personal in nature.

A number of other issues relating to other types of fringe benefits have recently been raised. It may be appropriate to consider educational assistance programs in conjunction with an overall examination of fringe benefits rather than separately.

